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EUROZONE MACRO UPDATE: ENCOURAGING ACROSS THE BENCH

Berenberg Macro Flash

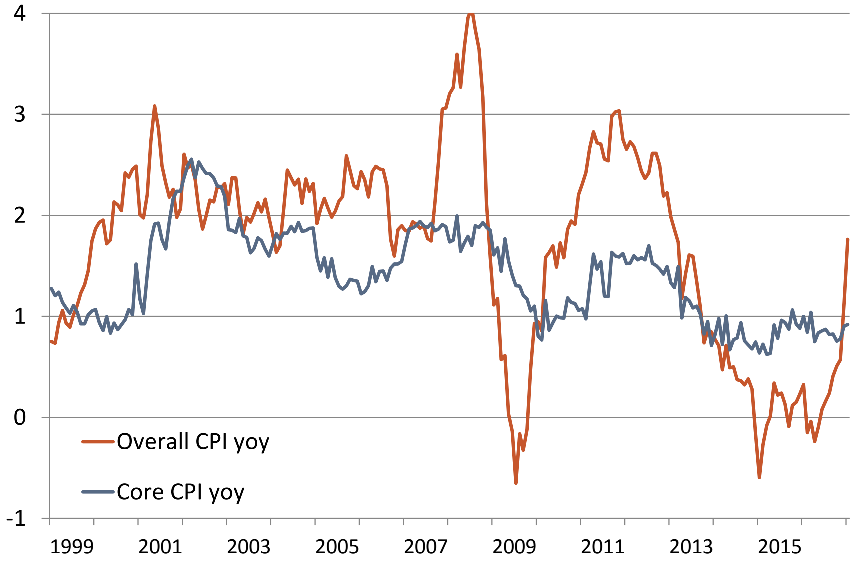
Economic fundamentals are encouraging, output is expanding at around trend, labour market continues to improve and core inflation will follow suit, but remains well below target.

GDP – economic activity is improving. In line with consensus expectations and slightly above the Eurozone's trend rate of 0.4% in the previous quarter, economic growth rose to 0.5% in Q4 2016. For the first reading, Eurostat provides only the aggregate GDP figure, but we expect that private consumption, on the back of an improving domestic situation, and investment, partly correcting for the drag in Q3, were the major contributors to the headline number. Net exports may also have contributed to growth – Eurozone exporters benefit from the competitively valued Euro (EURUSD down 6% qoq in Q4). On 14 February, a second flash estimate follows, with the final reading including main aggregates scheduled for 7 March. Growth was driven by economic strength in the core – earlier data showed that activity in France, Spain and (likely) Germany accelerated versus Q3. The outlook remains positive. Leading indicators such as the PMIs and the European Commission's sentiment indicators show that confidence either held up or even improved at the start of 2017. With a small fiscal stimulus in most parts of the Eurozone, a very accommodative ECB monetary policy and a competitively valued exchange rate, the Eurozone is on track for a year of solid growth averaging 0.4% qoq per quarter and 1.5% for the year overall in 2017. While a potential fiscal boost in the US and the on-going global upturn in demand suggest an upside risk to our outlook, political risks (Trump protectionism, Le Pen election win, Italian referendum on euro etc.) loom larger than before and warrant some modest caution.

Inflation – mind the gap: Headline inflation in January accelerated significantly in January, to 1.8% yoy, from 1.1% in December. Headline inflation is poised to stay a little below the ECB's target during Q1, but the recent strong rise is mainly due to base-effects from volatility in commodity prices. In the second quarter and for the rest of the year, as base effects drop out of the annual growth rate calculation, we expect the yoy rate to drop to below 1.5%. Do these numbers force the ECB to change its monetary stance? No. Draghi made very clear in the last press conference that for the ECB to change its policy stance they would look for a durable and self-sustained convergence of inflation towards the target of "below, but close to 2%" across the whole Eurozone over the medium-term. The next growth and inflation forecasts the ECB provides after its next meeting on 9 March, may give an insight, whether the assessment is changing. We don't expect that – a change in the assessment would be rather premature. Core inflation, which excludes the volatile energy and food components, and is a measure of underlying price pressures did not increase versus the previous month. It remained flat at 0.9%, well below the ECB's target (**see chart 1**). We expect underlying forces of demand and supply not to generate a rise in core inflation to the ECB's target for at least the next 18 months. This is broadly implied by the ECB's asset purchase programme which runs at least until summer 2018, assuming asset purchases until the end of 2017 followed by some tapering.

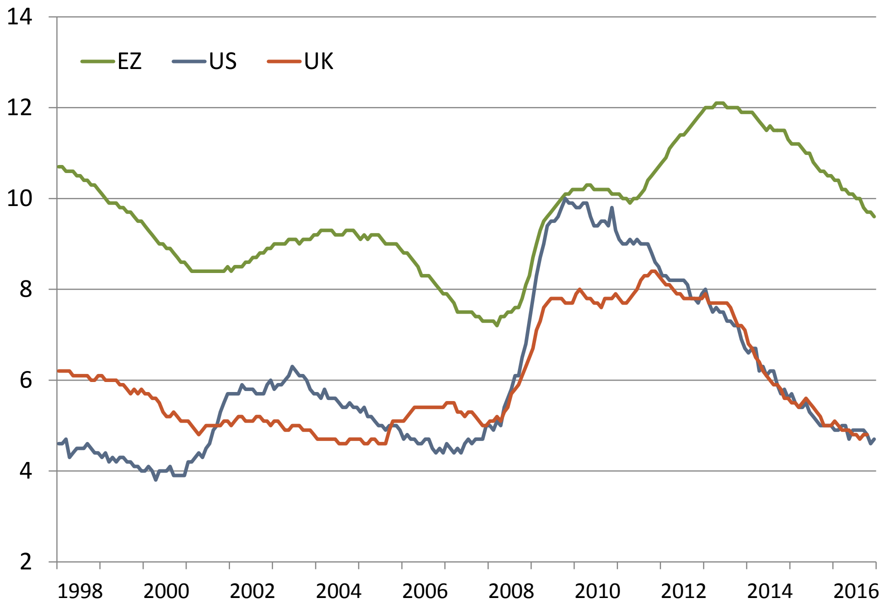
Unemployment edging down: The labour market surprised on the upside, with the unemployment rate for the Eurozone dropping from a revised 9.7% to 9.6% when? This was the lowest level since April 2009. While it remains roughly twice as high as in the US and the UK, the Eurozone has made significant progress since the peak of the unemployment rate of 12.1% in June 2013 (**see chart 2**), with the unemployment rate falling by 0.8% annually on average over the last three years. With the Eurozone recovery lagging the US and UK by 2-3 years in terms of GDP and the labour market, progress needs to continue for unemployment to return to its average pre-Lehman recession level of around 8%.

Chart 1: Headline CPI versus core inflation (yoy, in %)



Source: Eurostat

Chart 2: Unemployment rate – Eurozone, US and UK (in %)



Harmonised unemployment rate in %. Source: Eurostat

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